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Sharing Arrangements - A Warning

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fiable support order may not be entitled to full faith and credit is inconsequential, since, by virture of the above definition, the act states that effect must be given to such non-final judgments. By adopting this registration provision, the legislature has emphatically granted more than is required by the full faith and credit clause. Furthermore, the registration procedure is very similar to that of the Uniform Enforcement of Foreign Judgments Act.[34] Texas has not adopted this uniform act, but registration of a modifiable support order has been upheld by a sister state which has adopted it.[35]

IV. Conclusion

Many uncertainties in the application of the U.R.E.S.A. exist, as is to be expected in an act which is designed to apply in all states. It is understandable then, that problems will arise when each state attempts to apply it under its particular laws. However, the wording and spirit of the new act indicate the willingness of the Texas Legislature to foster comity and cooperation. Any uncertainties in the act should be judicially resolved in accordance with the obvious legislative intent. The new Texas act is almost identical to the latest Uniform Act of the the State Commissioners. Previous versions of the U.R.E.S.A. have been adopted by all states; therefore, there are excellent prospects of unprecedented inter-state cooperation on a national scale. Today's highly mobile society makes full compliance with the new act a necessary and very desirable goal.

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Sharing Arrangements — A Warning

I. General Tax Provisions

Section 61 of the Internal Revenue Code of 1954 defines gross income for tax purposes as "all income from whatever source derived" including compensation for services.[1] The concept of income includes property received as well as cash. Thus, when services are exchanged for property, the fair market value (as closely as may be ascertained) must be reported as income.[2] This rule has been

[34] 9A Uniform Laws Annotated 474 (1965).
[35] Light v. Light, 12 Ill. App. 2d 502, 147 N.E.2d 34 (1957). See Comment, 27 Mo. L. Rev. 500 (1962).

[1] Int. Rev. Code of 1954, § 61.
[2] Treas. Reg. § 1.61-(2) (1957).

applied in a number of cases in which interests in oil properties were received in exchange for the contribution of various services not concerned directly with the development of the properties.[3]

II. Sharing Arrangements and Partnerships in Oil and Gas Taxation

Several exceptions to these general rules exist in the field of oil and gas taxation. This note will consider these exceptions in the light of two recent decisions of the Fifth Circuit Court of Appeals.

A. *Sharing Arrangements*

A sharing arrangement is one in which the grantor, usually the owner of an oil lease, conveys an interest in the minerals in return for some contribution which aids in the development of the property.[4] The assignee shares the burden and the risk of developing the property with the owner; he obligates himself to participate directly in the development and to look solely to his interest in the minerals for any possibility of reimbursement or profit.[5] In the case of a service contributor, the agreement may provide that the contributor is entitled to no return on this "investment of capital" until the grantor recovers his expenses.

The Internal Revenue Service first stated the tax consequences of the sharing arrangement transaction in S. M. 3322[6] in which the service acknowledged that when services (*e.g.*, the drilling of a well) were exchanged for a part of the working interest, the grantor recognized no taxable gain or loss.[7] The tax effect upon the assignee in a sharing arrangement was considered in G. C. M. 932 which stated that where "the very drilling costs constitute the consideration for the acquisition of the producing rights [they] can be nothing else but capital investment returnable by way of depletion against production."[8] Later decisions[9] have developed the position that one who drills a well and receives an interest in minerals in return, has

[3] Massey v. Commissioner, 143 F.2d 429 (5th Cir. 1944); Walls v. Commissioner, 60 F.2d 347 (10th Cir. 1932) (legal services); Thomas Blake, 20 T. C. 721 (1953). *Cf.*, Parr v. Scofield, 185 F.2d 535 (5th Cir. 1951) (commission for securing leases).

[4] Breeding and Burton, Taxation of Oil and Gas Income 38 (1954).

[5] *Ibid.*

[6] IV-1 Cum. Bull. 112 (1925).

[7] *Ibid.* See also, Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); Rogan v. Blue Ridge Oil Co., 83 F.2d 420 (9th Cir. 1936), *cert. denied*, 299 U.S. 574 (1937); Thompson v. Commissioner, 28 F.2d 247 (3d Cir. 1928).

[8] VI-1 Cum. Bull. 241 (1927).

[9] Dearing v. Commissioner, 102 F.2d 91 (5th Cir. 1936), *affirming* 36 B.T.A. 843 (1936). See also, Commissioner v. Edwards Drilling Co., 95 F.2d 719 (5th Cir. 1938), *affirming* 35 B.T.A. 341 (1935); Cook Drilling Co., 38 B.T.A. 291 (1938).

made an investment in the oil and gas in place and therefore recognizes no taxable income at the time of investment.

G. C. M. 22730[10] collected and analyzed the earlier decisions in this area and concluded that drillers, equipment dealers, and investors who contribute to the acquisition and development of oil property, in exchange for an economic interest in that property, have made a capital investment and will recognize no income with respect to the interest received.[11] In reaching this conclusion, the ruling adopted the "pool of capital" reasoning first employed in *Palmer v. Bender*.[12] According to this doctrine, the character of the oil in place is that of a reservoir of the capital investments of the parties entitled to share in the properties under the agreement. The assignee relieves the assignor of a portion of the risks, costs, and burdens of development, in return for which he obtains a capital asset; therefore, the contributor's costs should be capitalized and not expensed. This capital investment is recovered by way of depletion.[13]

In order for transactions to be included within the scope of the ruling, certain basic requirements must be satisfied:[14]

(1) The contribution must add to the pool of capital necessary to develop the property (*i.e.*, it must assist in performing an exploratory or developmental function necessary to bring the property into production).

(2) The interest received must be in the same property in connection with which the contributions were made and it must be expressly agreed that such an interest will be acquired.

(3) The contributor must look solely to the economic interest acquired for any possibility of profit.[15]

This ruling exempts from taxation only the receipt of the property interest. Any subsequent income received from the property will be recognized and taxed as ordinary income.

G. C. M. 22730 does not expressly describe an instance in which one contributing services receives an interest; but because drillers must contribute services as well as equipment, the ruling would seem to cover an interest acquired in exchange for services. This

[10] 1941-1 Cum. Bull. 214 (1941).

[11] *Id.* at 221.

[12] 287 U.S. 551 (1933).

[13] *Id.* at 558.

[14] G. C. M. 22730, 1941-1 Cum. Bull. 214.

[15] If, in addition to his interest, the contributor should receive cash or other property, it is generally recognized that he may realize a taxable gain or loss through his receipt of the cash or other property, but the receipt of the economic interest is still regarded as a nontaxable transaction. See, G. C. M. 22332, 1941-1 Cum. Bull. 228; and, Shelton, *The Taxation of Oil and Gas Interests Received in Payment for Property or Services*, Southwestern Legal Foundation, Fifth Annual Inst. on Oil and Gas Law and Taxation 440 (1954).

position has been followed in many private ruling letters issued by the Internal Revenue Service to taxpayers stating that geologists, brokers, lawyers, and accountants providing services in connection with the development of the property in exchange for an interest therein recognized no taxable income.

This position appears to have been adopted by the Fifth Circuit in *Commissioner v. Rowan Drilling Co.*,[16] although the court never expressly mentioned the ruling. Relying on the same cases which form the basis of G. C. M. 22730, the court stated:

> It is no longer open to doubt that the ownership of oil in place is a capital asset, and that the acquisition price of the asset, whether paid in cash or services, is a capital investment that may not be treated as a business expense for income-tax purposes, but must be recouped by depletion deductions from gross income.[17]

B. *Partnerships*

No gain or loss is recognized when one contributes property to a partnership in exchange for an interest in that partnership.[18] Similarly, a service contributor recognizes no taxable income except where an existing partner relinquishes to the contributor any part of his right to be repaid his capital contribution (as distinguished from his share of partnership profits).[19] In the latter case, the service contributor will be treated as dealing with the partnership individually and not as a partner, and the value of any property which the contributor receives will be considered taxable income under section 61.[20]

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[16] 130 F.2d 62 (5th Cir. 1942).

[17] *Id.* at 63.

[18] Int. Rev. Code of 1954, § 721.

[19] Treas. Reg. § 1.721-1(b)(1) (1956) states:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services, section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest.

For supporting case authority, see Ferris v. Commissioner, 222 F.2d 320 (10th Cir. 1955); Haphold v. Commissioner, 141 F.2d 199 (5th Cir. 1944); Weiner v. Campbell, 44 A.F.T.R. 1251 (N.D. Tex. 1953). See also Rev. Rul. 54-84, 1954-1 Cum. Bull. 284.

[20] *Ibid.*

III. LEWIS v. COMMISSIONER[21]

At the request of the owners of the lease, Lewis, a petroleum engineer, made a preliminary study and made certain proposals with respect to installing a waterflood program on a lease. In November, 1953, Lewis and two of the principal owners reached a basic agreement which provided that if and when the owners of the lease elected to proceed with a full scale waterflood program, Lewis would prepare a schedule of production and, upon approval of the owners, would supervise the operation. Compensation for his services theretofore rendered was to be $35,000. Compensation for future services was to be $65,000, payable out of production, if and when the total proceeds from 1/8 of 7/8 of total production amounted to $35,000. When the oil payment had been paid, he was then entitled to a fractional overriding royalty. This agreement was not acted upon until May, 1956, when a pilot waterflood program was initiated by Lewis at the owners' request. In September, 1957, a full scale program was begun, and in October, 1957, the oil payment and overriding royalty value were assigned. The Revenue Service claimed that the fair market value of the oil payment and royalty should be treated as income.

Lewis argued that although it does not expressly mention strictly personal services, G. C. M. 22730 should be applied; that one who performs engineering services in exchange for an interest in the oil properties has made as equally an essential contribution to the "pool of investment" required to bring the property into production as one who provides equipment as well as services. The Commissioner contended that since G. C. M. 22730 does not expressly mention engineers or others contributing strictly personal services, such an interpretation should not be read into it. The Fifth Circuit, like the Tax Court before it,[22] did not decide the case on that issue, however, but held that since the services performed were in the area of production rather than development or exploration, G. C. M. 22730 was inapplicable. A waterflood program is a method of recovering oil from a present producing horizon by injecting water into the oiled sand in order to supplement the existing reservoir pressure. It had been generally felt that a waterflood program such as here existed was more in the nature of development than a producing or operating function.[23] Nevertheless, the court, after hearing expert testimony on

[21] 339 F.2d 706 (5th Cir. 1964).

[22] 39 T. C. 482 (1962).

[23] Fiske, Federal Taxation of Oil and Gas Transactions § 307 (1958); Kirgis and Turner, *Tax Aspects of the Receipt of an Economic Interest in Oil and Gas Property in Return for*

both sides, decided that it was a producing function in this case.[24] The court then stated an important dictum which suggests serious doubt as to the continued applicability of G. C. M. 22730 to any transaction involving an exchange of services for property. Judge Tuttle stated: "Unless a careful analysis of the reasons underlying the issuing of the G. C. M. 22730 compelled it, the Court would have great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as a part of gross income."[25] This statement appears to be particularly significant when considered with the decision of the same court in *Frazell.*

IV. UNITED STATES v. FRAZELL[26]

William Frazell was a geologist, who in February, 1951, entered into a contract with the W. H. Wheless Oil Company, a partnership. Frazell was to check certain areas to determine whether potentially productive oil and gas properties might be procured. In return for his services, Frazell was to receive "a monthly salary or drawing account" plus expenses and specified interests in the property acquired. He was not to be considered as owning an interest in the property until Wheless and Woolf recovered their full costs and expenses from the properties. By the early part of 1955, it became apparent that Wheless and Woolf would recover their entire costs and expenses by November, 1955. In April, 1955, the 1951 contract was terminated and the properties acquired under the earlier arrangement were transferred to the W. W. F. Corporation (formed specifically to acquire these properties) in return for the issuance of debentures to Wheless and Woolf and stock to Wheless, Woolf, and Frazell. Frazell's thirteen per cent of this stock had a fair market value of $91,000, but he included no part of this amount in his 1955 return.

Frazell argued that the agreement whereby he was to receive an interest in the oil properties was a joint venture or partnership arrangement. The Commissioner contended that the entire agreement was an employment contract in which the section anticipating the

Services Rendered, P-H Oil and Gas Taxes ¶ 1008.1 (1964); *Assignment of an Economic Interest for Personal Services,* 1 Oil & Gas Tax Q. 18 (1952); Shelton, *supra* note 15.

[24] In so doing, the Fifth Circuit cited the opinion of the Tax Court which stated: "The program consists of the introduction of water into the underground reservoir or oil sand for the purpose of . . . recovering oil in place from the present producing horizon." 339 F.2d 706, 710 (5th Cir. 1964).

[25] *Id.* at 709.

[26] 335 F.2d 487 (5th Cir. 1964), *cert. denied,* 380 U.S. 961 (1965).

transfer of a portion of the interest in the oil properties was merely expressing an additional means of compensation for services rendered. The district court concluded that a joint venture had been formed,[27] and section 351(a)[28] was applied to make the subsequent transfer of partnership property to the corporation in return for stock a non-taxable transaction. The court of appeals agreed that this was in fact a joint venture but reversed the district court, declaring that income was to be recognized by Frazell. According to the court, the transaction whereby Frazell obtained his share of the corporation's stock could be viewed in either of two ways: (1) that so much of the partnership interest traded for stock as was compensation for his services was taxable as ordinary income to him under Treasury regulation, section 1.721(b)(1),[29] or (2) so much of the stock received in compensation for his services was taxable under section 351(a).[30] The court did not wish to "split hairs and choose between them."[31] Since Frazell did contribute maps to the venture, however, the case was remanded to determine the value of these maps, as they would fall within the non-recognition provisions of section 351(a). In a short dissenting opinion,[32] Judge Hutcheson expressed agreement with the district judge's opinion and concluded that the Commissioner's position was highly technical and unsubstantiated.[33]

This decision confuses the interpretation of section 721 transactions as they apply to the oil and gas area. The agreement "that Frazell should not be entitled to, nor shall be considered as owning any interest until such time as Wheless and Woolf shall have recovered their full costs and expenses of said properties"[34] appears to contemplate a return of the capital contributions to W. and W., and therefore the transaction should be tax free. In the Fifth Circuit's opinion, only the latter portion of regulation 1.721-1(b)[35] was cited, and the first two sentences of the regulation were entirely omitted.

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[27] 213 F. Supp. 457 (W.D. La. 1963).

[28] Int. Rev. Code of 1954, § 351(a): "No gain or loss shall be recognized if the property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation. . . . For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property."

[29] See note 19 *supra.*

[30] See note 28 *supra.*

[31] 335 F.2d at 491.

[32] 213 F. Supp. at 470.

[33] Judge Hutcheson's concurring opinion in Commissioner v. Rowan Drilling Co., 130 F.2d 63 (5th Cir. 1942), was relied upon by the government. In this decision, Judge Hutcheson set forth the theory that a person receiving an oil payment for services rendered should be treated as though he had performed the services for cash and had taken that cash and invested it in the oil payment.

[34] 213 F. Supp. 457.

[35] See note 19 *supra.*

Counsel for Frazell then contended that the court in "overlooking" this portion of the regulation had committed error, and that an application of the remainder of the regulation to the facts of the case would require a contrary result. The court examined this contention upon rehearing[36] and concluded that had Frazell not been granted a thirteen per cent interest, Wheless and Woolf would have been entitled to the entire capital of the venture and that it was never contended, nor would the record support the contention that the recoupment was a return of capital rather than a skimming of profits.[37] Since this was a transfer of capital from one of the partners, the non-recognition provisions of section 721 did not apply.

In order to apply the court's alternative to this fact situation, Frazell's partnership interest would have to be considered non-possessory at the time of the issuance of the stock so that the transaction would fall without the non-recognition provisions of section 351(a).[38] The fact that Wheless and Woolf had not recouped their entire costs at the time of the transfer of stock might be used to support this reasoning. The substance of the 1951 agreement, however, clearly indicates that Frazell's carried interest became possessory before the transfer of the stock and that the stock transfer was merely formal evidence of his previously obtained property rights.[39]

G. C. M. 22730 and the doctrine of tax-free receipt for services under the pool of capital theory is never mentioned in either the district court or the court of appeals decisions. Possibly, the court is denying the application of the sharing arrangement concept because the partnership provisions of the Code may be applied. On the other hand, counsel for Frazell did not contend that such a sharing arrangement concept should be applied. The issue was raised only in

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[36] United States v. Frazell, 339 F.2d 885 (5th Cir. 1965).

[37] Had he [Frazell] not been so compensated, Wheless and Woolf woud have been entitled to the entire capital of the venture. In transferring a 13% interest to Frazell, they necessarily gave up a portion of their own capital interests. This fact is in no way altered by their having reserved the right to take the first $1,245,106 out of the profits of the venture. It has never been contended that this recoupment was a return of capital to Wheless and Woolf rather than a skimming of profits, and no such contention could be supported on this record.

339 F.2d at 886.

[38] See note 29 *supra*.

[39] Frazell had an economic interest which requires merely a right to share in the oil produced (even though legal title may be in the hands of another), and this interest is possessory. Treas. Reg. 118, § 39.23(m)-1(b) (1956), defines economic interests: "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures by any form of legal relationship, income derived from the severance and sale of the mineral . . . to which he must look for a return of capital."

See also Commissioner v. Happold, 141 F.2d 199 (5th Cir. 1944).

one of the amicus curiae briefs[40] where it was contended that Frazell first acquired an interest in the properties through a taxfree exchange for services under G. C. M. 22730 and then contributed his interest to the partnership along with the interests contributed by the other owners. In reply, the government contended that the services were rendered to the partnership which, in turn, invested in the properties. Whether the court agreed that G. C. M. 22730 was not applicable in this case or whether it simply did not utilize it since the partnership provisions also apply is not completely clear.

There is considerable doubt as to just what reasoning the court did apply to the problems raised in *Frazell*.[41] Originally, the basic ground of contention was whether the agreement was in substance an employment agreement or a joint venture agreement. Although the courts called it a joint venture agreement, they seemed continually perplexed by a situation which was complicated by the fact that "the parties did not expressly regulate all the incidents of their legal relationship,"[42] and just how much this apparent doubt as to the nature of the agreement might have influenced their decision cannot be ascertained.

V. Conclusion

Read independently, the *Lewis* and *Frazell* decisions seem to be of limited significance. The opinion in *Lewis* would merely indicate that after weighing conflicting expert testimony, the court concluded that a waterflood program was a type of productive activity and therefore, according to recognized principles, would not fit into the classification of non-taxable transactions contemplated under G. C. M. 22730. Assuming this determination, the other views expressed by the court, although quite strongly worded, should be considered as dicta and nothing more. In *Frazell*, the court, in a particular fact situation, viewed the transaction as the shifting of capital from one

[40] Brief for Frazell as Amicus Curiae.

[41] Counsel for the United States submits that the court adopted the following reasoning in reaching their conclusion:

1) the value of property received for services regardless of form, is taxable as ordinary income.
2) the value the taxpayer received was primarily in return for services.
3) it was taxable when received or when it accrued.
4) the taxpayer initially received a substantially restricted right to future compensation in the form of a full participating interest in the joint venture's properties.
5) the restrictions were removed from the right when the venture was liquidated and the taxpayer given stock having a determinable market value.
6) at that time he realized income.

Brief for Petitioner, p. 8.

[42] 213 F. Supp. 457 (W.D. La. 1963).

partner to the service contributor and thus constituting a taxable transaction under either section 351(a) of the Internal Revenue Code or 1.721-1(b) of the Treasury regulations.

When read together, however, the decisions may be significant. The fact that the same court which issued a strong condemnation of the non-recognition principles of G. C. M. 22730 has in a companion case refused to apply this ruling to a fact situation in which it appears to be squarely in point reflects serious doubts as to the continued vitality of the non-recognition doctrine. Additional hints of a change in position have recently occurred but these can hardly be considered conclusive.[43]

Dissatisfaction with the decision in *Lewis* stems from the questionable classification of a waterflood program as an element of production. If the principle underlying G. C. M. 22730 is to be abandoned, the proper procedure is to issue a new ruling to this effect; amending the principle through court decisions which penalize those who have relied upon it is clearly inequitable. As for G. C. M. 22730 "flying in the face" of the general tax provisions, a careful analysis of the reasoning behind it should indicate that such transactions are a form of capital investment (highly speculative investments at that), and should not result in a recognition of income.[44]

To interpret *Frazell* as weakening the "pool of capital" doctrine is to read something into the case which simply is not there. Frazell's attorney never argued that G. C. M. 22730 applied; he chose to base his argument solely on the partnership rules, particularly those dealing with the return of partnership capital; and thus, the precedent value of the case is extremely uncertain.

Certain peculiarities will probably limit the decision to its particular facts. The agreement involved was drafted primarily as an employment agreement by the attorney for Wheless and Woolf. He was naturally striving to obtain maximum tax benefits for his client and did not necessarily have Frazell's best interests at heart. As a result, the carelessly drafted contract failed to separate properly the compensation terms from the carried interest arrangement. The characterization of the instrument as an employment agreement seems to have infected the whole proceeding.

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[43] A most interesting development is the recent modification of the regulations under section 704 of the Code which contemplates the "carrying" of service contributors. One example under this regulation was changed so that now one who is characteristically a capital contributor (a business proprietor) is entitled to a share in the partnership profit as opposed to the previous example of one who is characteristically a service contributor (electronics engineer). 1964-2 Cum. Bull. 177.

[44] See notes 10-13 *supra* and accompanying text.